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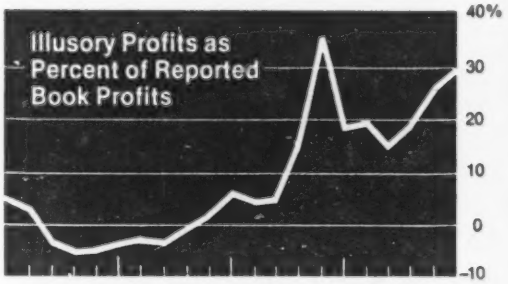
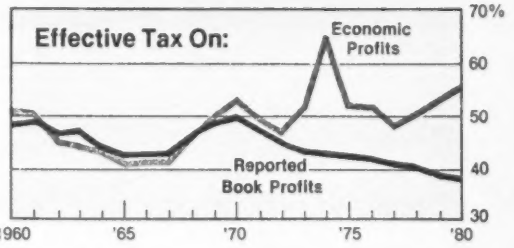
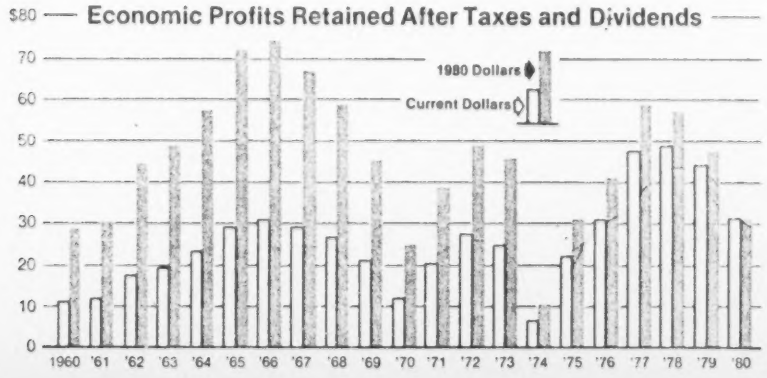
Profits– True and Illusory

Economic Road Maps
No. 1903 May, 1981

Corporate operations in the United States reported $211 billion of pretax profits in 1980. However, almost 30% of this figure consisted of "illusory" profits that is, amounts that are reported to stockholders as profits under conventional accounting methods but that are not in truth available for dividend payout or reinvestment in the business. The cost of the fixed capital used up in production is generally understated by conventional accounting methods, and the same is often true of the cost of inventories used. This understatement of costs means overstatement of profits. "Economic" profits, which are reported book profits conservatively adjusted to eliminate undercosting, were $152 billion in 1980. While reported book profits were off 5% from 1979, economic profits dropped 9% before taxes and 12% after taxes.

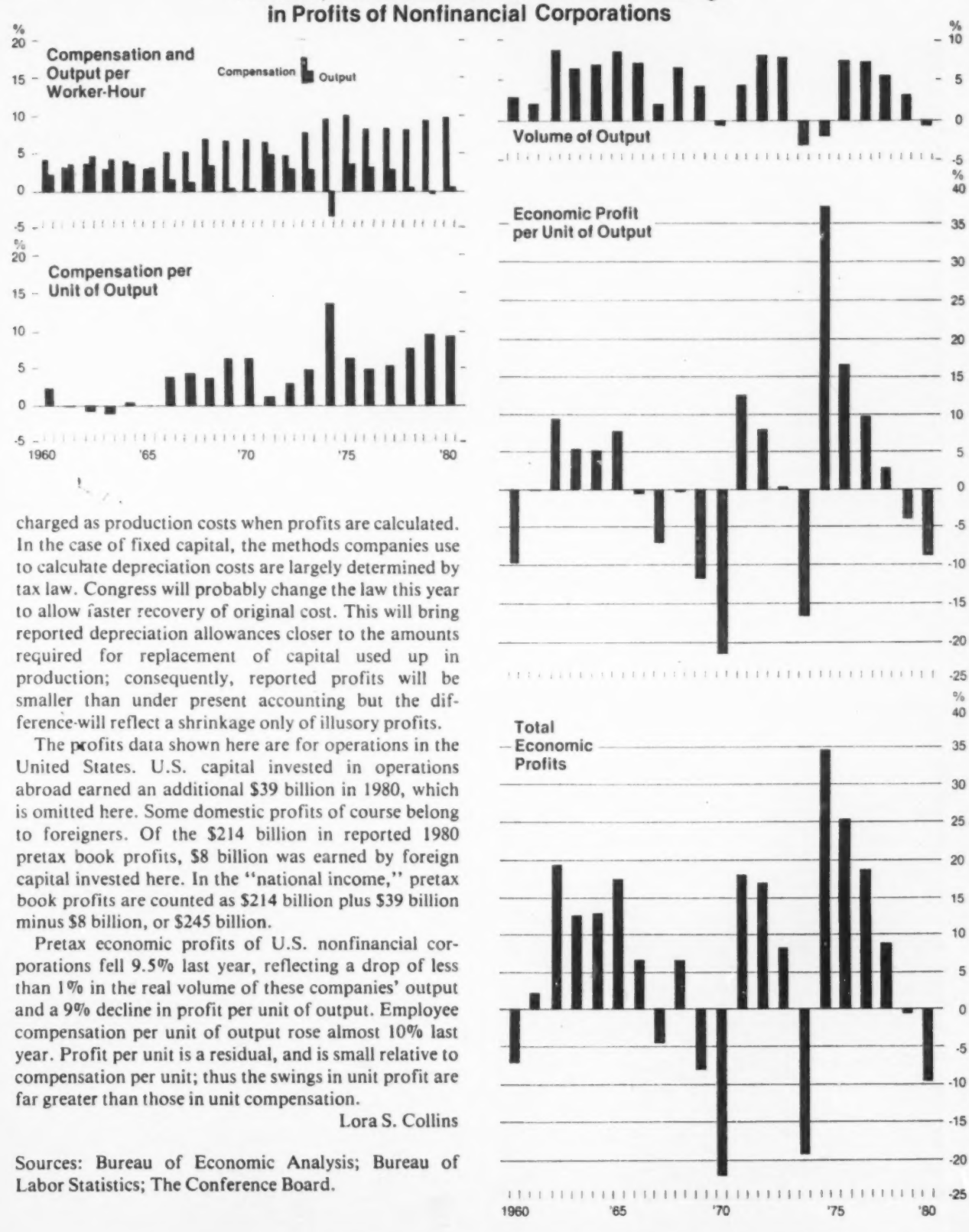






Taxes are calculated on reported book profits. While the average tax on book profits (counting federal, state and local corporate income taxes) was 38% last year, the rate on economic profits was 54% (chart immediately above). The gap between the apparent tax rate and the rate on economic profits reflects serious inflation, for inflation is the key to the understating of economic costs and overstating of reported profits: It is because of inflation that the replacement costs of fixed capital and inventories often exceed the allowances for depreciation and cost of materials that are

Factors that Determine the Year-to-Year Change in Profits of Nonfinancial Corporations



charged as production costs when profits are calculated. In the case of fixed capital, the methods companies use to calculate depreciation costs are largely determined by tax law. Congress will probably change the law this year to allow faster recovery of original cost. This will bring reported depreciation allowances closer to the amounts required for replacement of capital used up in production; consequently, reported profits will be smaller than under present accounting but the difference will reflect a shrinkage only of illusory profits.

The profits data shown here are for operations in the United States. U.S. capital invested in operations abroad earned an additional $39 billion in 1980, which is omitted here. Some domestic profits of course belong to foreigners. Of the $214 billion in reported 1980 pretax book profits, $8 billion was earned by foreign capital invested here. In the "national income," pretax book profits are counted as $214 billion plus $39 billion minus $8 billion, or $245 billion.

Pretax economic profits of U.S. nonfinancial corporations fell 9.5% last year, reflecting a drop of less than 1% in the real volume of these companies' output and a 9% decline in profit per unit of output. Employee compensation per unit of output rose almost 10% last year. Profit per unit is a residual, and is small relative to compensation per unit; thus the swings in unit profit are far greater than those in unit compensation.

Lora S. Collins

Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; The Conference Board.

ECONOMIC ROAD MAPS

Eva Culen, Editor — Chuck N. Tow, Lead Chartist

Prepared in The Business Conditions Analysis Department—Lora S. Collins, Director
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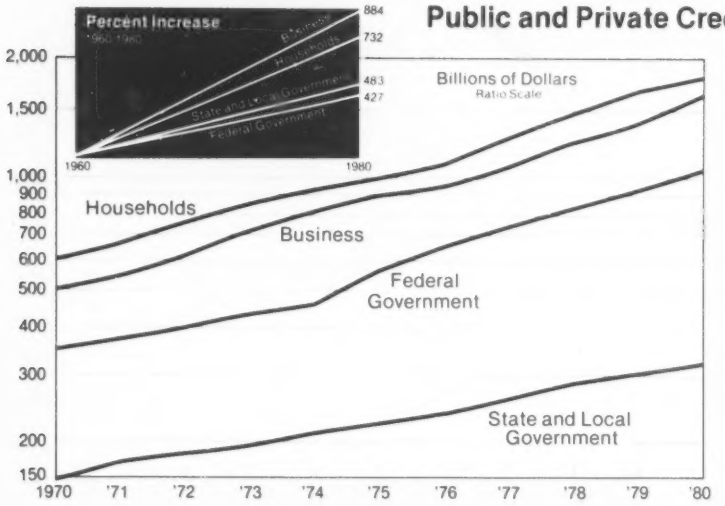
Borrowing and Lending in U.S. Credit Markets

Economic Road Maps

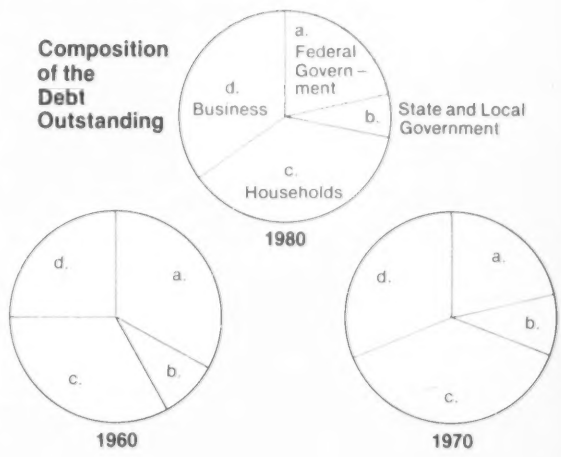
Nos. 1904-1905 June, 1981

The economic function of credit markets is to provide channels through which the excess funds of those who are spending less than their current income can be transferred into the hands of those who want to spend more than their income. In the United States, a highly developed, widely accessible, and well-functioning transmission mechanism assures a steady flow of these funds. The Federal Reserve Board calculates the so-called flow-of-funds accounts that are designed to show explicitly the complex financial interrelationships in the U.S. economy. This system makes it possible to sort out the components of borrowing and lending in U.S. credit markets.

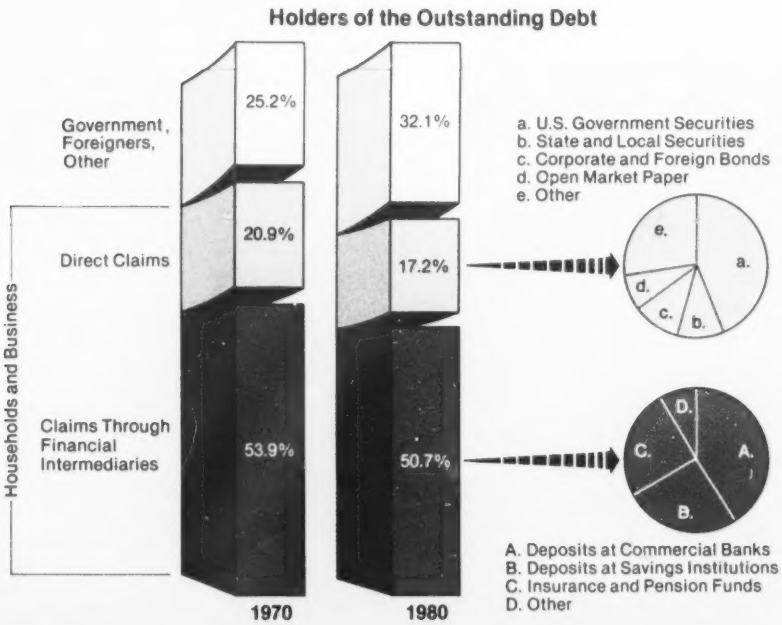
Public and Private Credit-Market Debt Outstanding



Composition of the Debt Outstanding



Holders of the Outstanding Debt

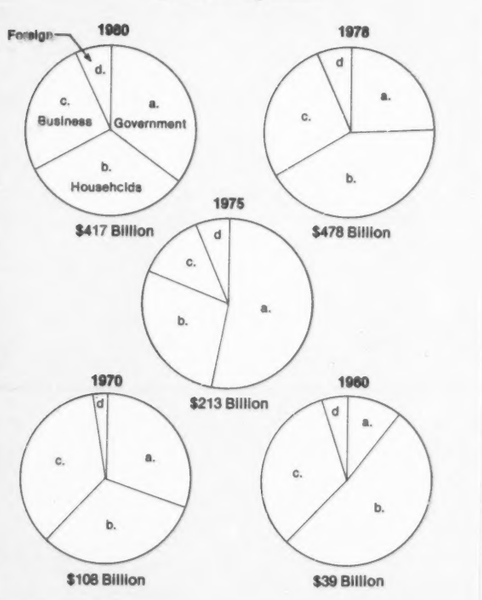


Since 1960, total government and private credit-market debt outstanding in the United States has increased roughly sevenfold. Over this period, households and businesses drew on the credit markets to a much larger extent than federal, state and local governments. This resulted in a significant shift in market shares. The household share of total debt increased from 33% to 37% in the past 20 years, and the business share soared from 25% to 35 percent. On the other hand, the Federal Government's share of outstanding debt fell from 33% of the total in 1960 to 22% in 1970, then changed little in the ensuing ten years. In the 20-year period from 1960 to 1980, state and local government's share of total debt fell by approximately one-fourth.

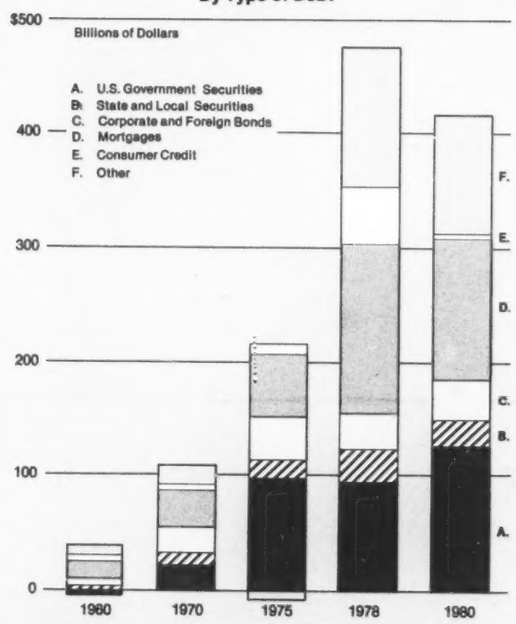
On the lending side of the credit markets, households and private businesses likewise account for the largest share of outstand-

Borrowing in Credit Markets

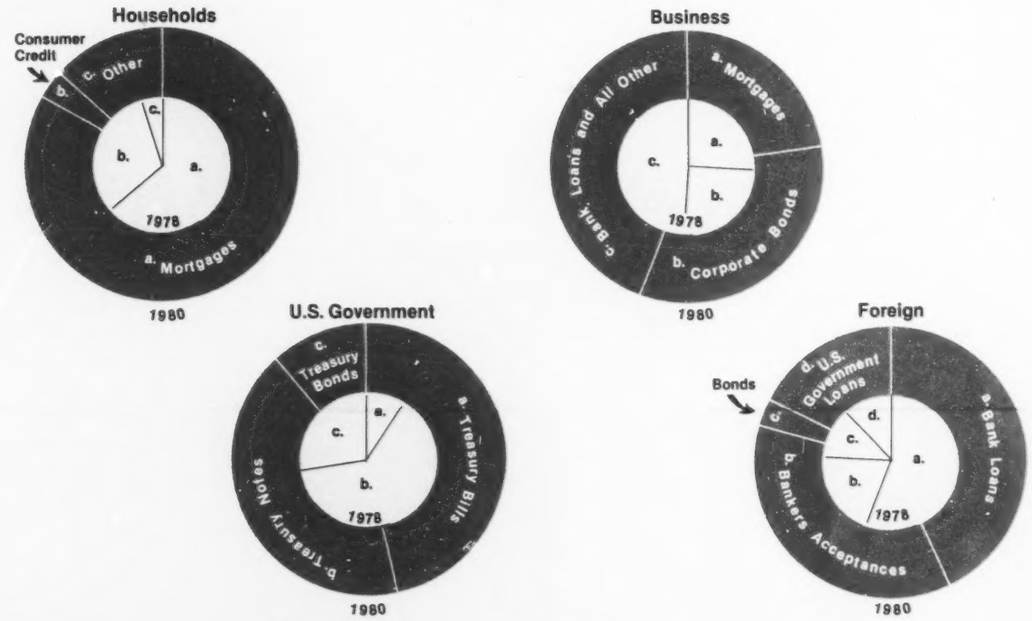
By Borrowing Sector



By Type of Debt



Detail on Borrowing



ings. However, their share has been declining—from three-quarters of the total in 1970 to two-thirds in 1980. These two sectors make most of their investments in credit-market debt through financial intermediaries such as commercial banks and thrift institutions.

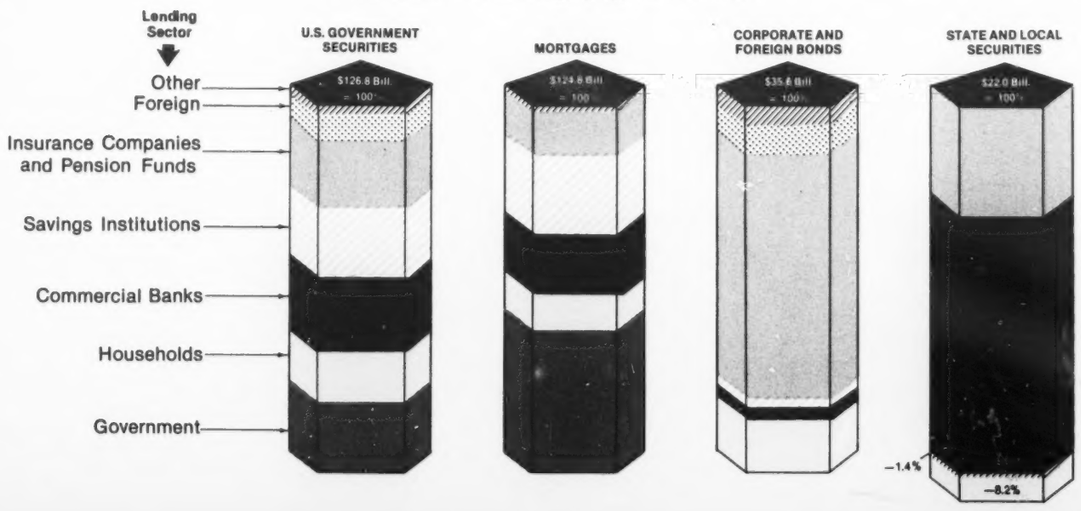
The demands made on credit markets have grown briskly over the years. The total amount raised by all types of borrowers, including financial institutions, reached an all-time peak of $478 billion in the boom year 1978. In recessionary periods, such as 1975 and 1980, governments tend to borrow heavily, while private borrowing diminishes. The use of consumer credit was unusually weak in 1980 because of government actions aimed directly at curbing consumer borrowing. During upswings of the business cycle, the situation is reversed: In 1960 and 1978, for example, household and business borrowing were dominant in credit markets.

The Federal Government mainly issues marketable notes and bonds, although there are also some so-called nonmarketable issues, mainly savings bonds.

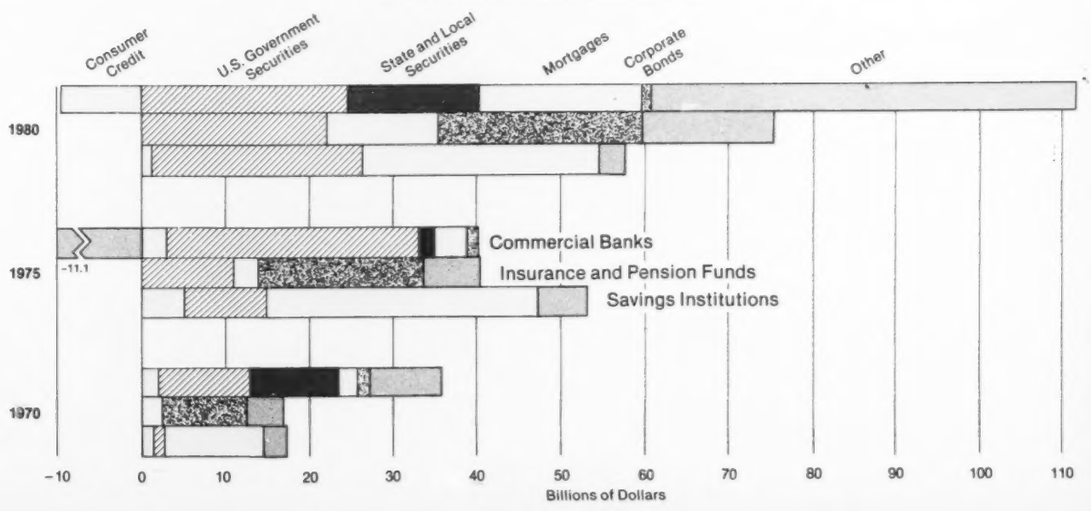
On the lending side of the market, the lending patterns reflect habit and custom as well as operational, legal and by-law constraints affecting different lenders. In 1980, for example, commercial banks and insurance companies together accounted for the entire acquisition of state and local government securities offered, whereas households on a net basis reduced their holdings of these securities by 8 percent. At the same

Lending in Credit Markets

Percent Share of Lending, by Type of Debt: 1980

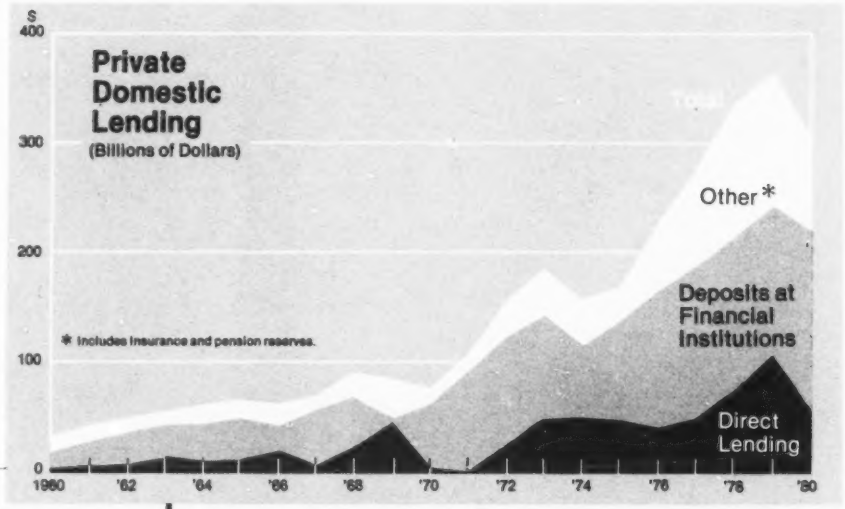


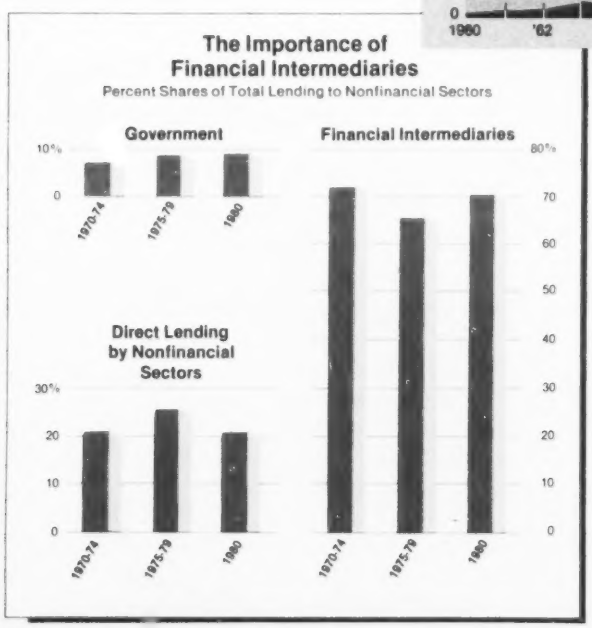
By Major Private Financial Institutions



time, pension funds and insurance companies took two-thirds of the new issues of corporate and foreign bonds, while in the mortgage market governments and government agencies were by far the most important lenders. (The government lending figures include mortgage pools.)

In 1980, credit-market lending by commercial banks totaled $103.5 billion, three times the amount in 1975. Savings institutions accounted for $57.6 billion of credit, and insurance companies and pension funds for $76.4 billion. A steady flow of funds from ultimate lenders to ultimate borrowers is carried by the process of intermediation, that is by flowing through such financial intermediaries as banks, savings institutions, insurance companies, and mutual funds. Intermediaries tend to specialize in offering particular forms of debt to the ultimate lenders, or in extending particular forms of credit to ultimate borrowers. Insurance companies, for instance, raise funds primarily through policy premiums but invest broadly in credit markets, while savings and loan associations borrow through savings accounts and lend through mortgages.



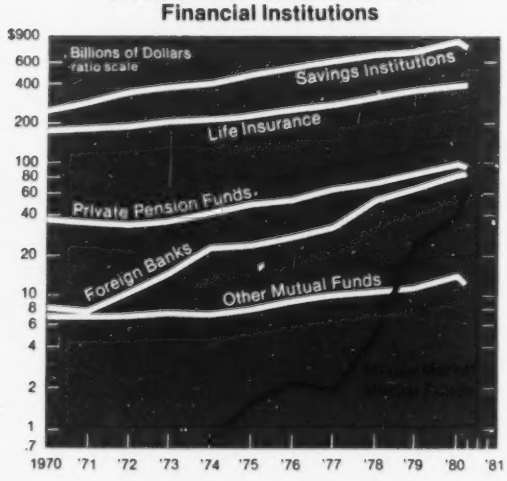


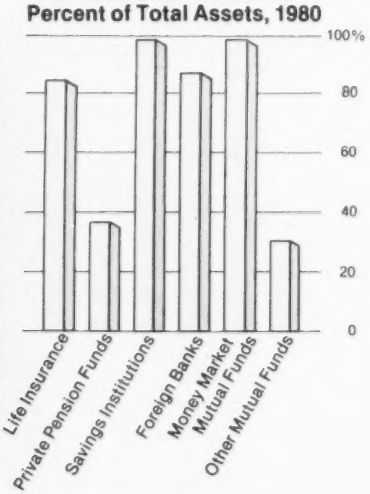
In the U.S. economy, a large part of all credit is channeled through intermediaries. The private sector as borrower relies mainly on financial institutions for mortgages, consumer credit, and business loans. Over the last ten years, financial intermediaries accounted for approximately 70% of total lending to nonfinancial borrowers. As lender, the private sector has also turned increasingly to deposits at intermediaries as an alternative to investing its money through the direct acquisition of securities.

The various financial intermediaries differ a great deal in the structure of their assets. Private pension funds, for instance, invest on average only about one-third of their assets in credit markets, with the bigger part going into corporate equities. On the other hand, savings institutions and money-market mutual funds hold practically nothing but credit-market assets.

Joerg Neef

Sources: U.S. Department of the Treasury; Federal Reserve Board; The Conference Board.





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Unemployment in Industrial Countries

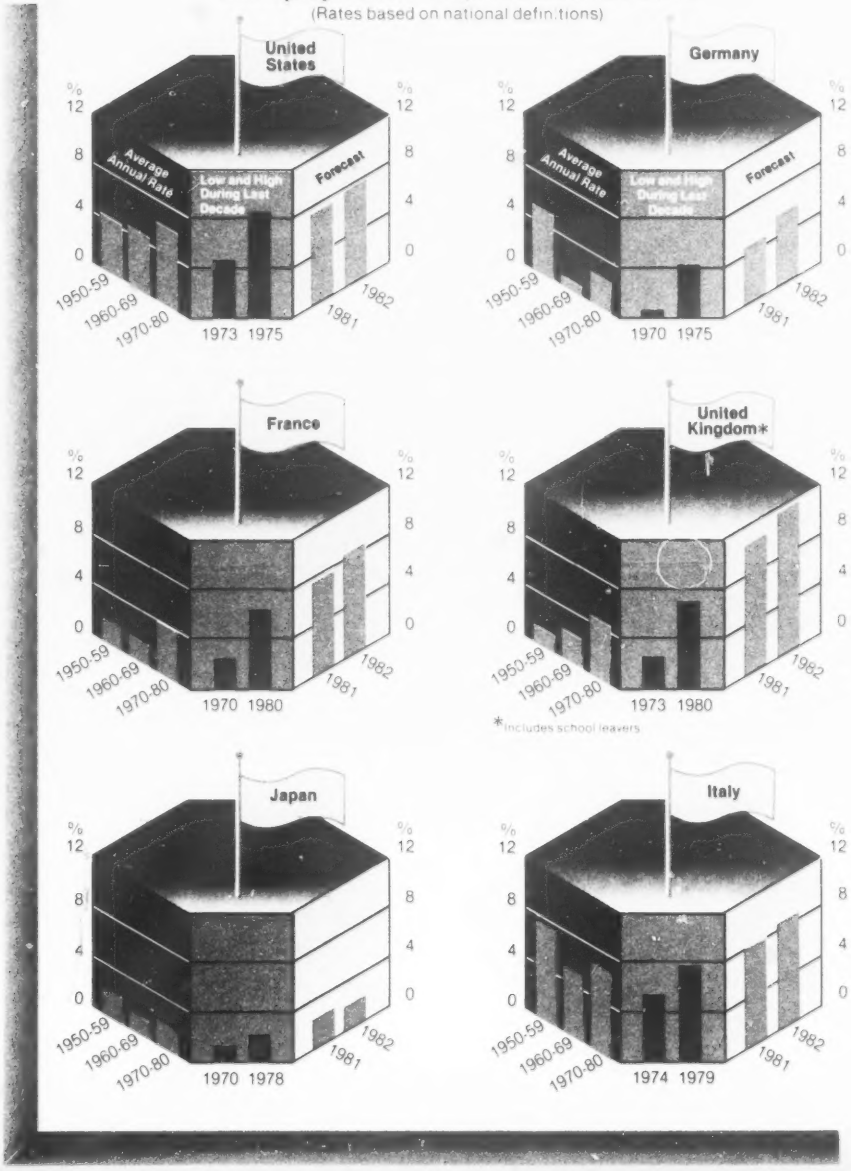
Economic Road Maps

Nos. 1906-1907 July, 1981

A pressing problem confronting the industrialized world today is a surge in unemployment. Since 1974, unemployment rates have been much higher for most western countries than the average rates for earlier years. In recent years, postwar highs in joblessness were reached in France and Great Britain, while German and Japanese rates were the highest since the 1950's. The situation is especially alarming to the governments of European countries, which for years have experienced low levels of unemployment; indeed, at one time they were importing millions of foreign workers in order to sustain their economic booms. The United States has usually lived with higher unemployment rates than those of European countries.

Unemployment - Past, Present and Future

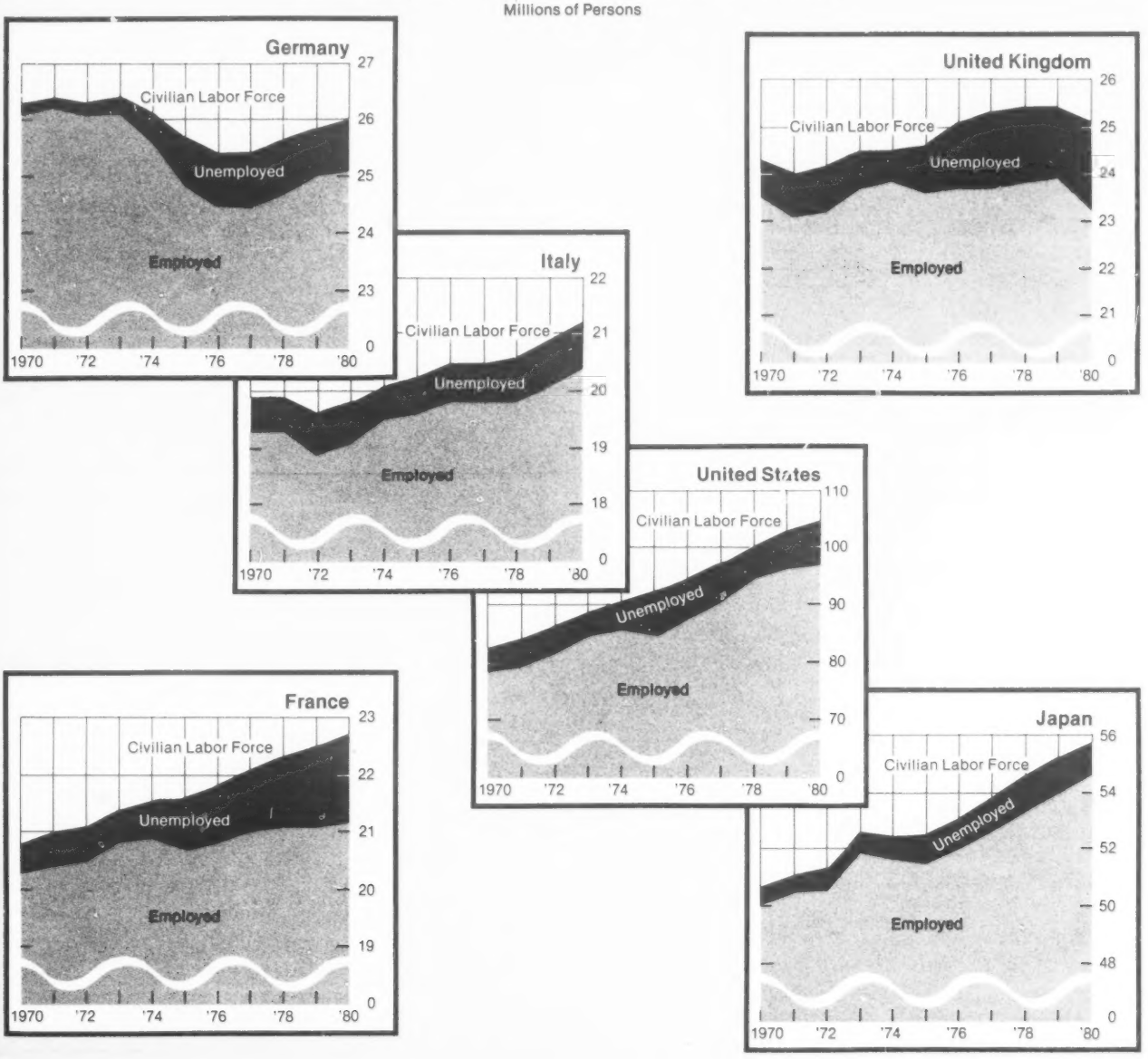
(Rates based on national definitions)

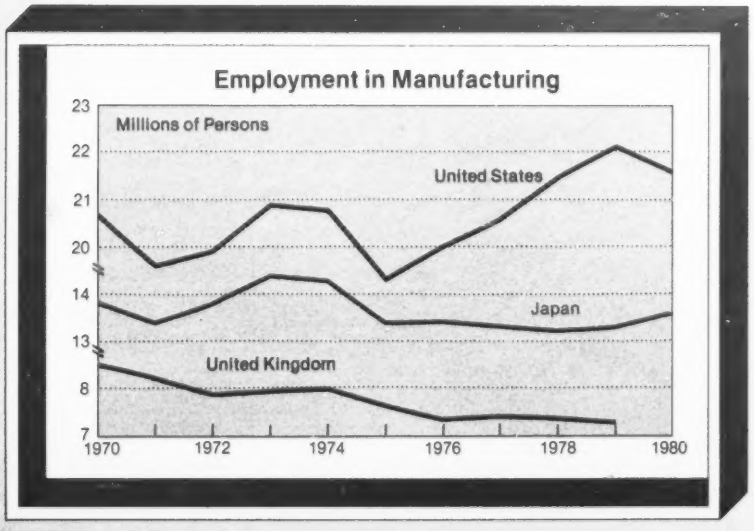


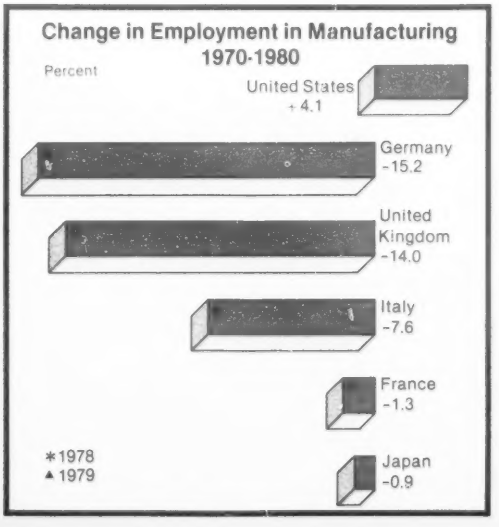
According to the latest projections by the Organization for Economic Cooperation and Development (OECD), the four major European countries will experience a decline of 1% in real GNP this year, followed by only a slight growth in 1982. For the United States, the OECD projections put real growth at 2½% this year and only 1% in 1982. (Many U.S. forecasters expect stronger, not weaker, overall growth in 1982, but the OECD projections are being used in this Road Map.) Japan, with a growth rate of 4% in 1982, will be the fastest growing of the major economies, although its growth will be well below the rates of previous years. Given this growth outlook, chances for improvement in the industrialized countries' employment situation are rather dim. The OECD expects unemployment to rise further this year and into the second half of next year, with women and young workers being the hardest hit. The number of unemployed in the Economic Community's member countries is about 8½ million, and it is expected to be near 10 million by this Winter according to the EEC Commissioner for Employment. U.S. unemployment is also expected to rise; only in Japan will it decline marginally. With the fight against inflation still preeminently on the minds of most governments, only the newly installed socialist government in France has put forth a pro-

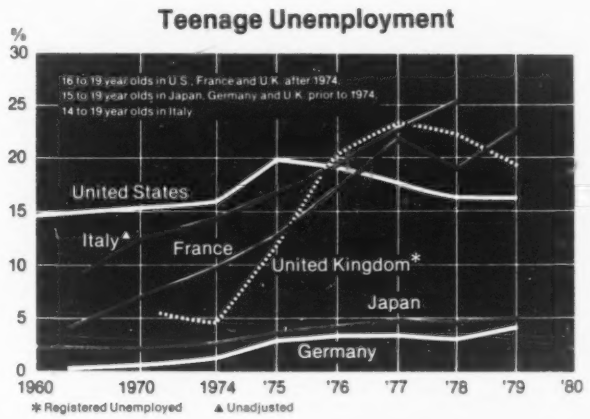
Unemployment Trends in Selected Countries

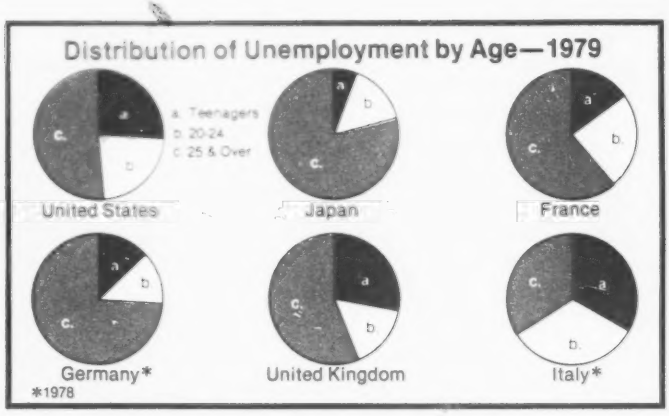
Millions of Persons





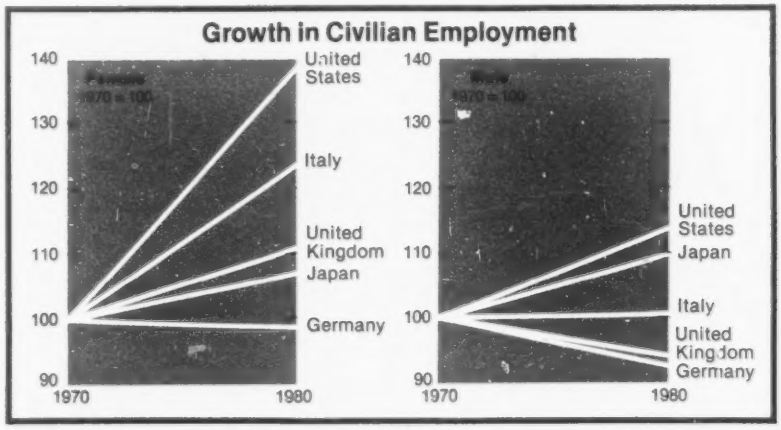


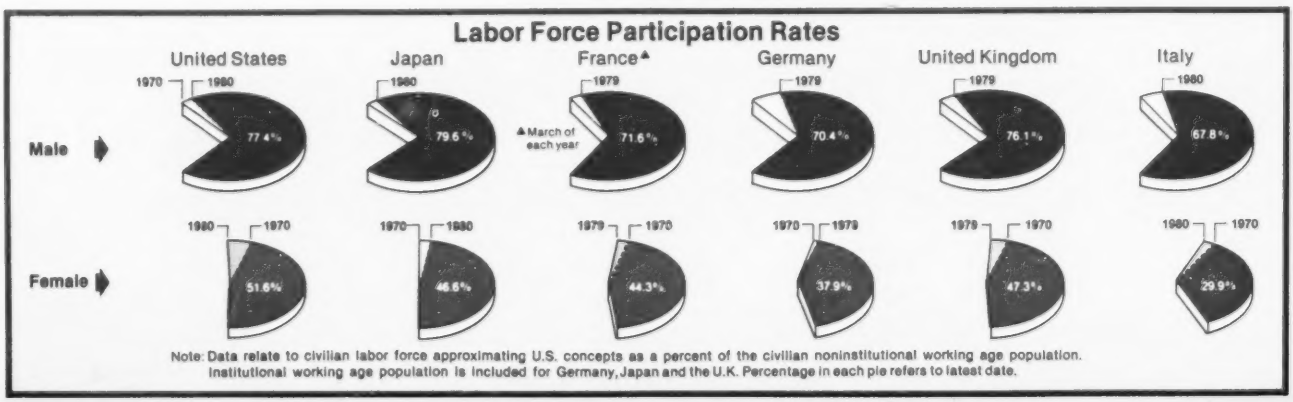

Teenage Unemployment
%
16 to 19 year olds in U.S., France and U.K. after 1974.
15 to 19 year olds in Japan, Germany and U.K. prior to 1974.
14 to 19 year olds in Italy.
United States
Italy▲
France
United Kingdom*
Japan
Germany
1960 1970 1974 '75 '76 '77 '78 '79 '80
* Registered Unemployed ▲ Unadjusted

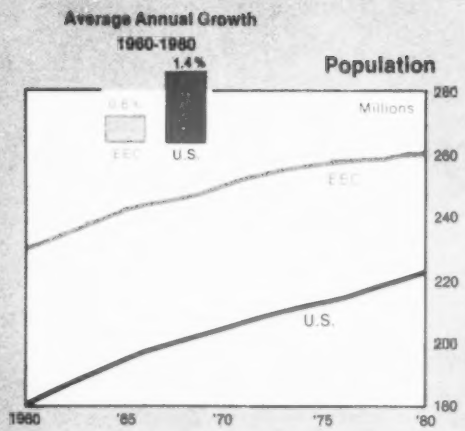


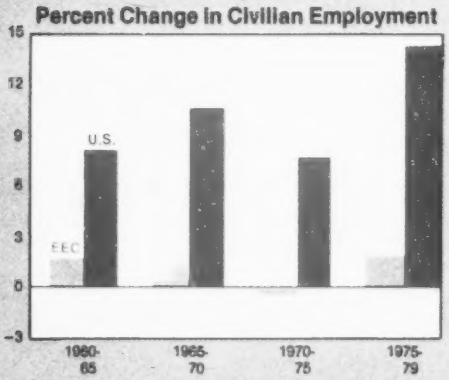
gram for creating new jobs. The British proposal to guarantee jobs for young school leavers—presented in the aftermath of the recent riots—seems to have been shelved, at least for the time being.

Labor statistics are among the most difficult economic indicators to compare internationally, and unemployment comparisons are the most difficult of all. The difficulties arise from differences in the systems for collecting data, as well as from differences in concepts or definitions. Some countries (France, Germany, the United Kingdom) collect their data from unemployment offices, which means that only those unemployed who bother to register are included. Others (United States, Japan, Italy) conduct sample surveys of the population. But even when similar methods are used, there can be substantial differences in definitions of labor force and employment—affecting, for instance, the treatment of military personnel, students, unpaid family workers, discouraged workers, and the age limits of the labor force. In the United States, for example, active job seeking within the past four weeks is required in order to be counted as unemployed, while in several foreign countries the survey week itself is the reference period for be-









ing counted as unemployed. To add further to the confusion, data are adjusted to different standards by various organizations: The U.K. unemployment rate in 1980 was calculated at 7% by the British government; the OECD listed it at 7.4%; the EEC calculations put it at 6.9%; while the U.S. Bureau of Labor Statistics adjustment to U.S. concepts resulted in a rate of 7.5 percent.

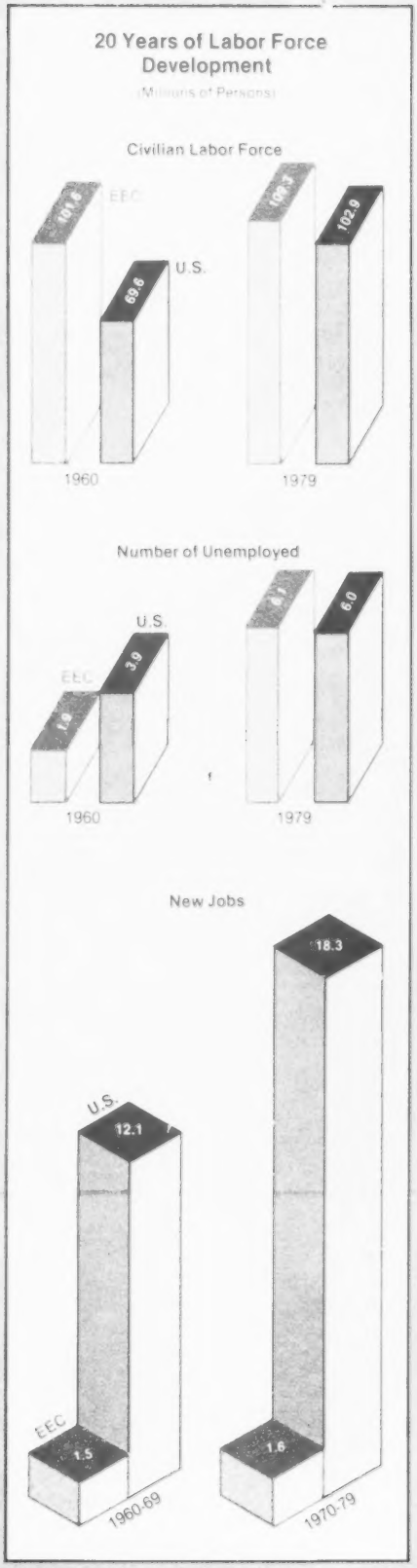
There are a variety of causes for the growth of unemployment in recent years. Social and demographic forces that brought a surge of youths and women into the job market were a factor. Also, there has been some migration of jobs over time from the developed to the developing countries. A number of countries have also been hit by structural unemployment, as workers were laid off in declining industries such as steel, shipbuilding and textiles. Developing new employment for such workers is in many cases, a time consuming process, requiring retraining and investment in growth industries.

In 1980, civilian labor force participation rates were highest in the United States (63.8%) and lowest in Italy (48%). A downward trend in participation rates for men has occurred in all countries, while the rate for women has fallen only in Germany and Japan.

Eva Culen

Sources: Organization for Economic Cooperation and Development; European Communities (EEC); U.S. Department of Labor; The Conference Board.

Note: Information on page 1 of the Road Map was compiled from OECD statistics based on the definitions used by each country. Figures for pages 2 and 3 (with the exception of the table on unemployment by sex which comes from OECD), present information adjusted by the U.S. Department of Labor to U.S. concepts. Page 4 is based on OECD statistics adjusted to international standards. The U.S. Department of Labor and the EEC Statistical Office compile the monthly unemployment rates.



Note: All EEC totals exclude Greece.

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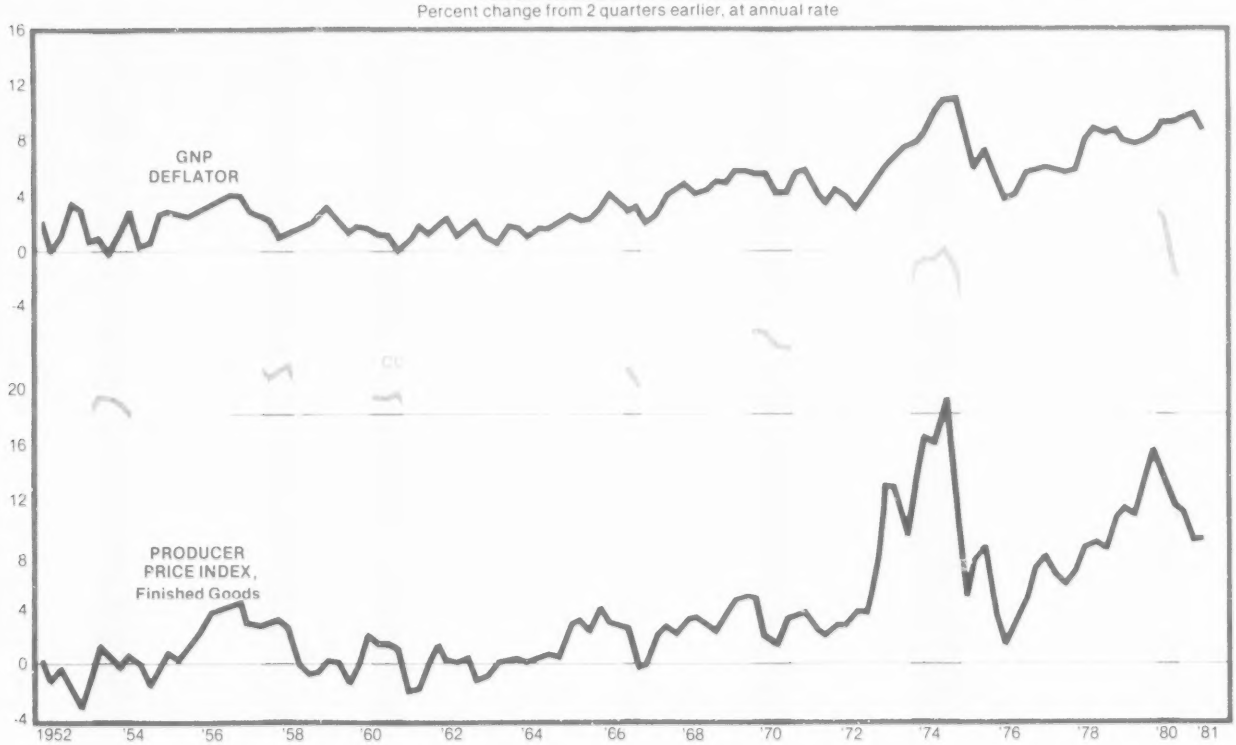
Inflation

Economic Road Maps
Nos. 1908-1909 August 1981

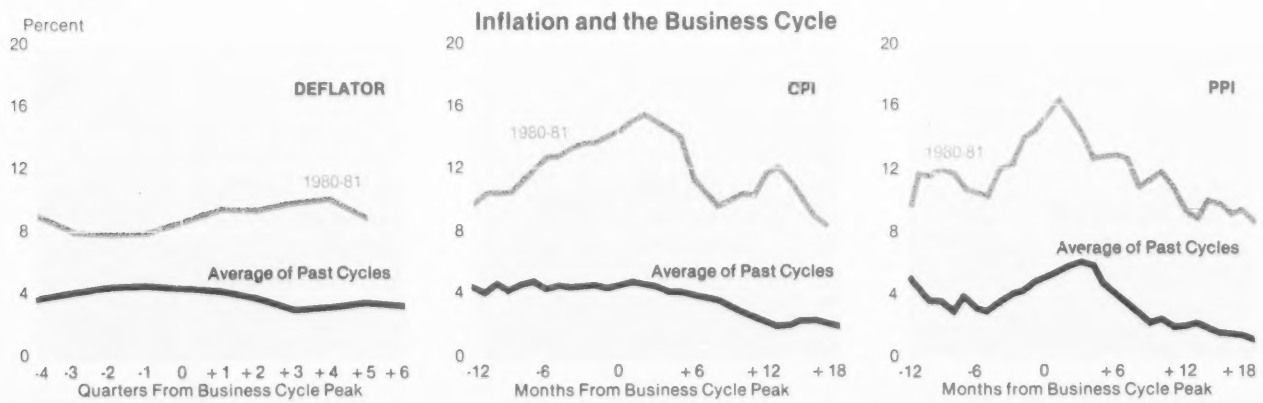
The phenomenon of inflation—a broad, general increase in prices—has become painfully familiar. Although most people probably have the consumer price index (CPI) in mind when they think of inflation, there are at least two other measures of broad price change: the producer price index (PPI) for finished goods, and the GNP deflator, which reflects the prices of all the goods and services produced by the U.S. economy. Despite their differences in coverage and weighting, the three indexes tell essentially the same story of an accelerating inflation trend over the past 15 years or so. There have been dramatic increases in energy and food prices in recent years, but inflation is a much broader phenomenon. Page 2 shows that the CPI and PPI excluding energy and food have generally risen about as fast as the overall indexes.

Three Measures of Inflation

Percent change from 2 quarters earlier, at annual rate

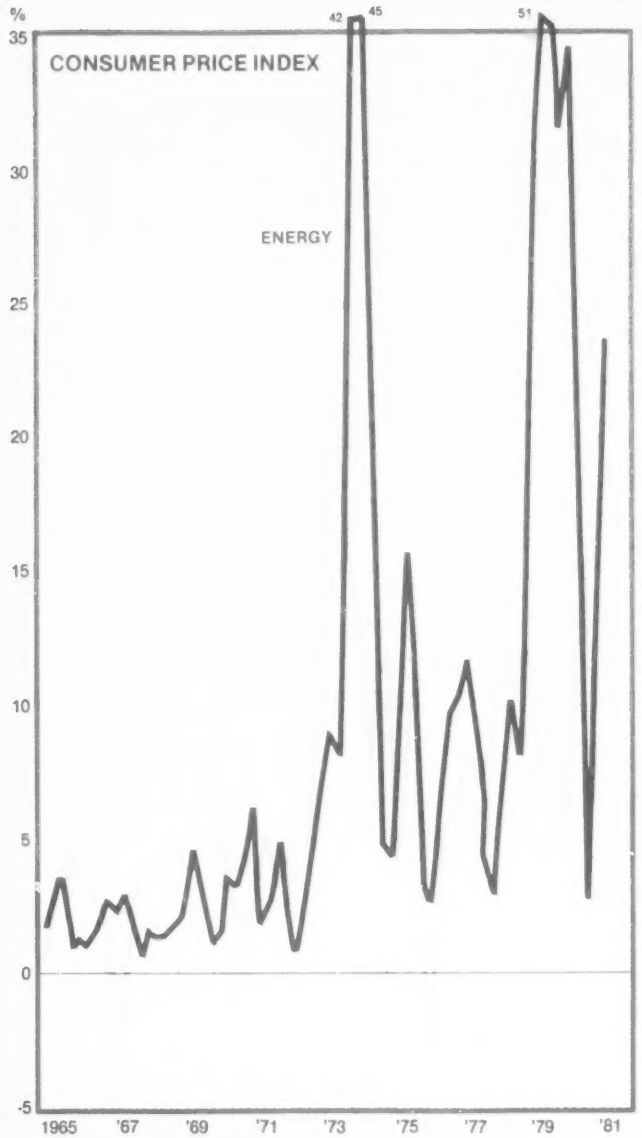


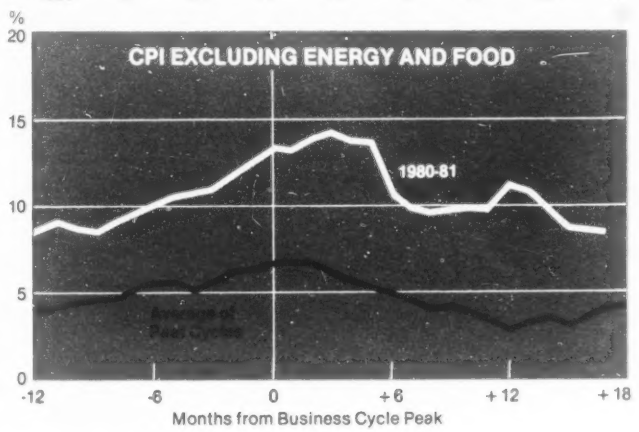
Inflation and the Business Cycle

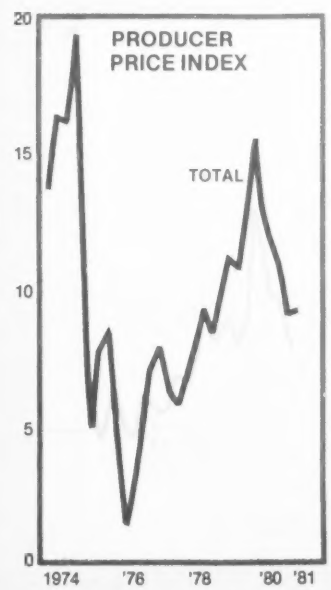


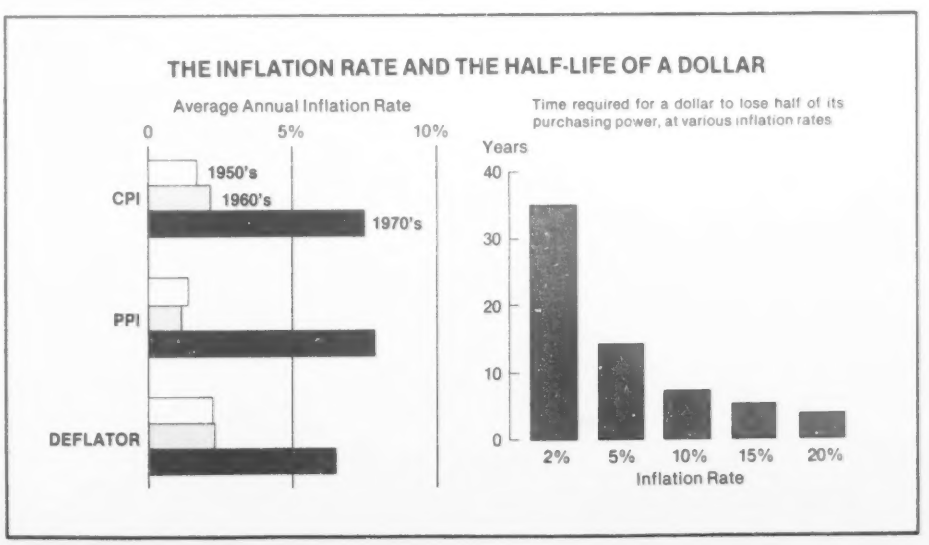
Food and Energy in the Price Indexes

Percent change from 2 quarters earlier, at annual rate



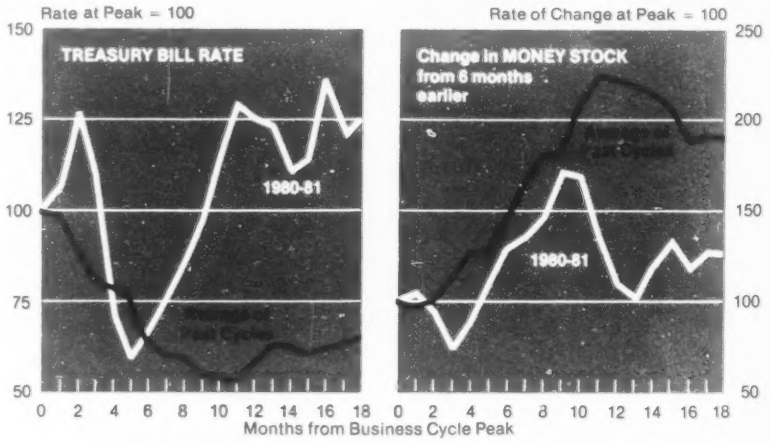




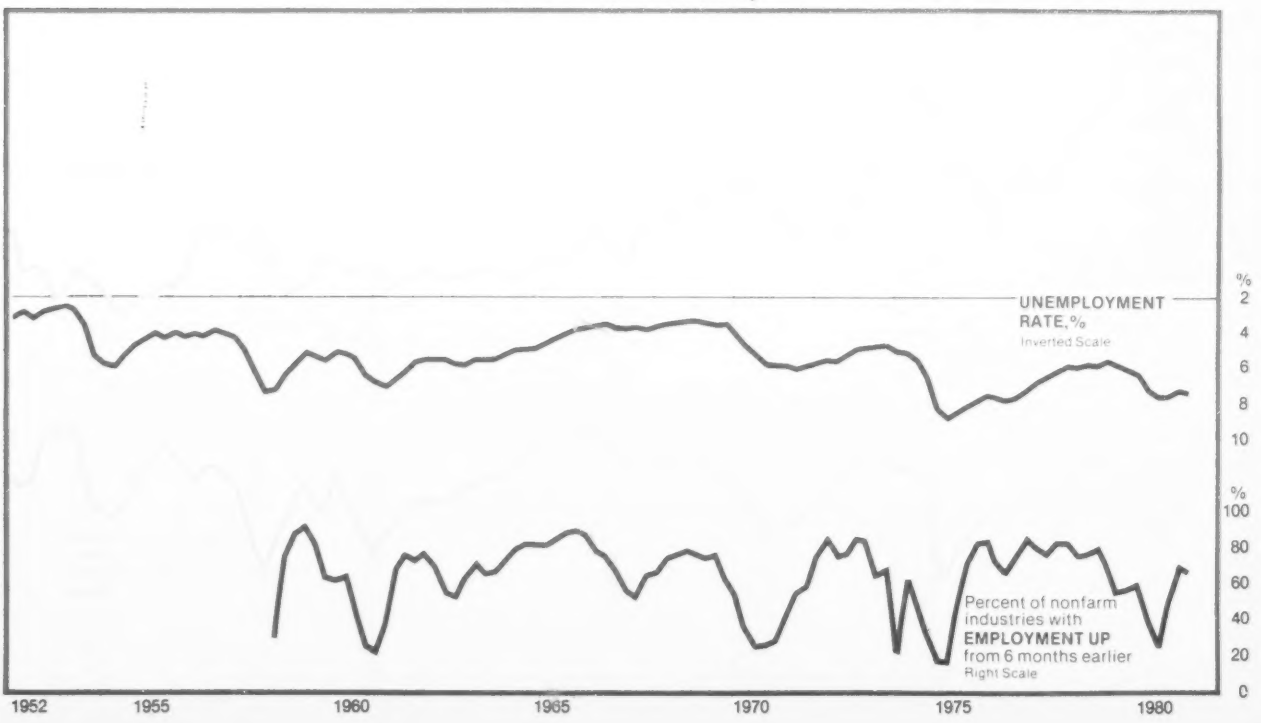


Monetary Policy

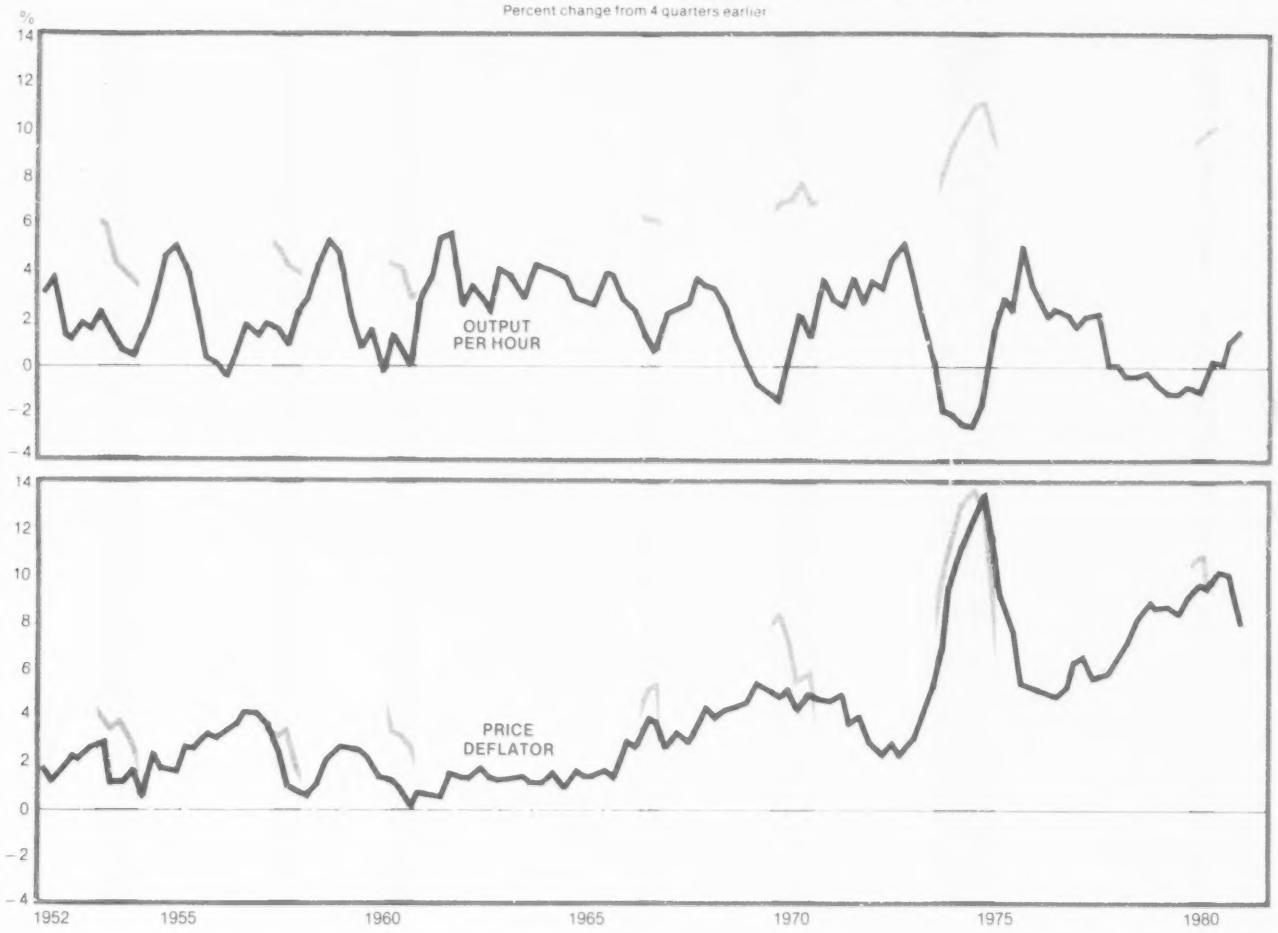
The record shows that we have had very little in the way of price decelerations except in connection with economic slumps. (The shaded recessions on the charts include the 1966-1967 quasi-recession, but it is not included in the averages of past cycles shown on the small charts.) A typical reaction to slumps has been a speed-up in the growth of money and credit, that is, of total dollar demand. In 1980-1981, however, the Federal Reserve seems determined not to pump out enough dollars to support both rising prices and rising real activity. Most economists

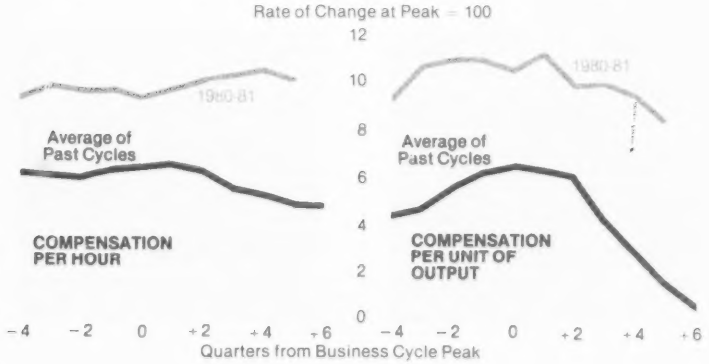


Inflation and Economic Activity



Labor Costs and Inflation in Nonfarm Business





agree that such a policy will ultimately stem inflation by starving it; the difficulties lie in the fact that most economists also believe that what is dampened in the first instance is real activity, not inflation.

Reports have shown inflation slowing down this year. A good deal of this slowing reflects essentially transitory factors such as the oil "glut" and unexpectedly flat food prices. Even so, the slowdown could temper attitudes and expectations throughout the economy, and that could affect the ongoing trend rate of inflation. The key to the basic trend of prices is the trend of labor cost, because that comprises the bulk of the total cost of the "factors of production" that produce the national output. Over time, leaving out short-term wiggles, if compensation trends up faster than output, the price level will rise. The adjacent charts show that since 1975, compensation per hour has been rising at 8% to 10% per year and accelerating, while the growth of output per hour has decelerated. The difference between those trends shows up as the rise in compensation per unit of output, which largely determines the rise in the price level.

Lora S. Collins

Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; Federal Reserve Board; The Conference Board.

ECONOMIC ROAD MAPS

Eva Culen, Editor — Chuck N. Tow, Lead Chartist

Prepared in The Business Conditions Analysis Department—Lora S. Collins, Director
Prices for Quantities of this chart will be supplied on request to Information Service.

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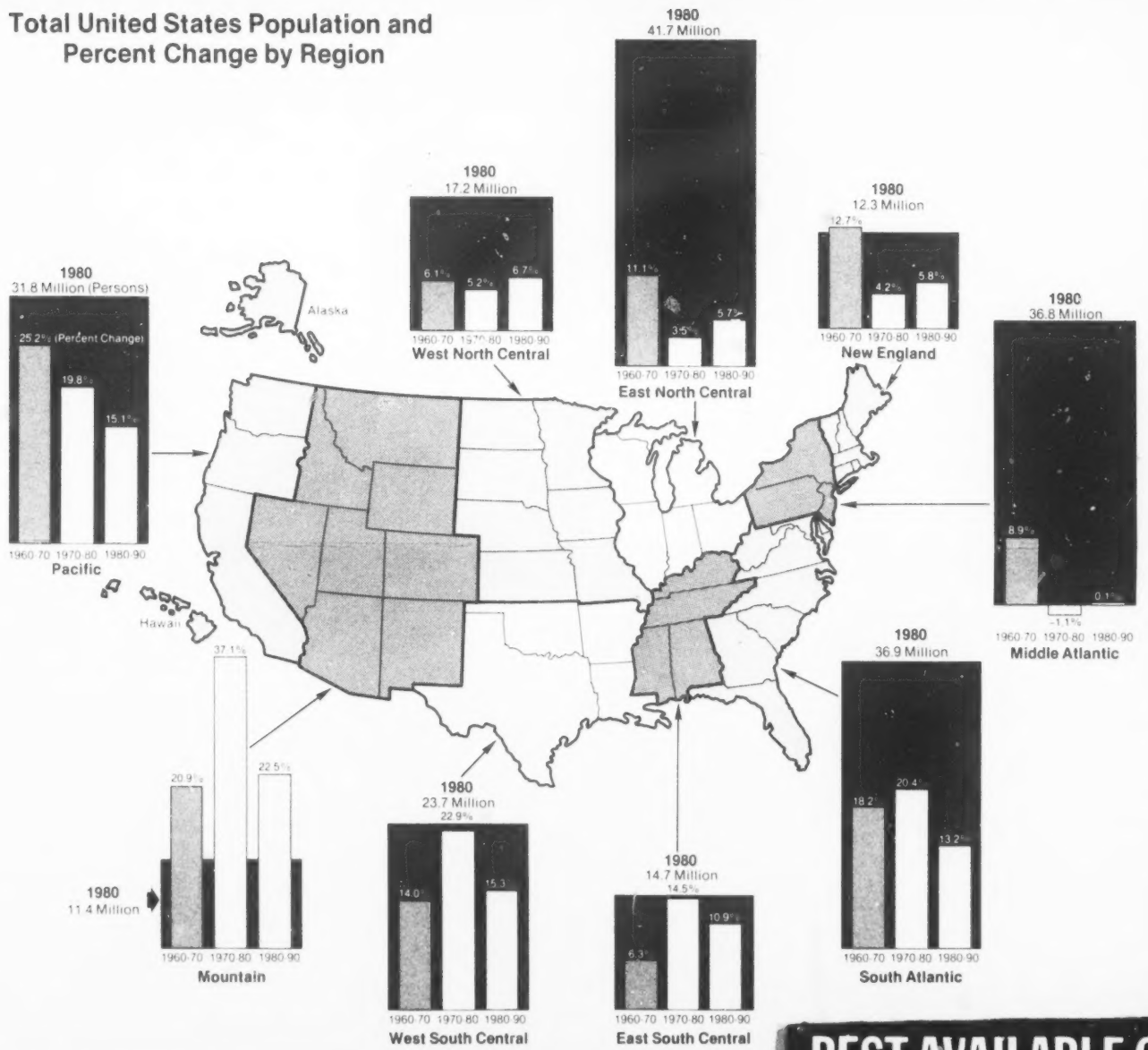
Population and Labor Force Trends

Economic Road Maps

Nos. 1910-1911 September, 1981

In economic terms, the "population problem" can be considered as the pressure of people on resources. Another way to think about it is as the pressure of people on people. The rate at which the population grows, the rate at which population density changes, and the differences in these factors among geographic regions all affect social relationships. The relationship between population and labor force is expressed by the labor force participation rate—that is, the proportion of the working-age population working or actively looking for work. In the last 20 years, the overall participation rate has risen, a trend that will continue in the 1980's if the Bureau of Labor Statistics' assumptions are correct.

Total United States Population and Percent Change by Region



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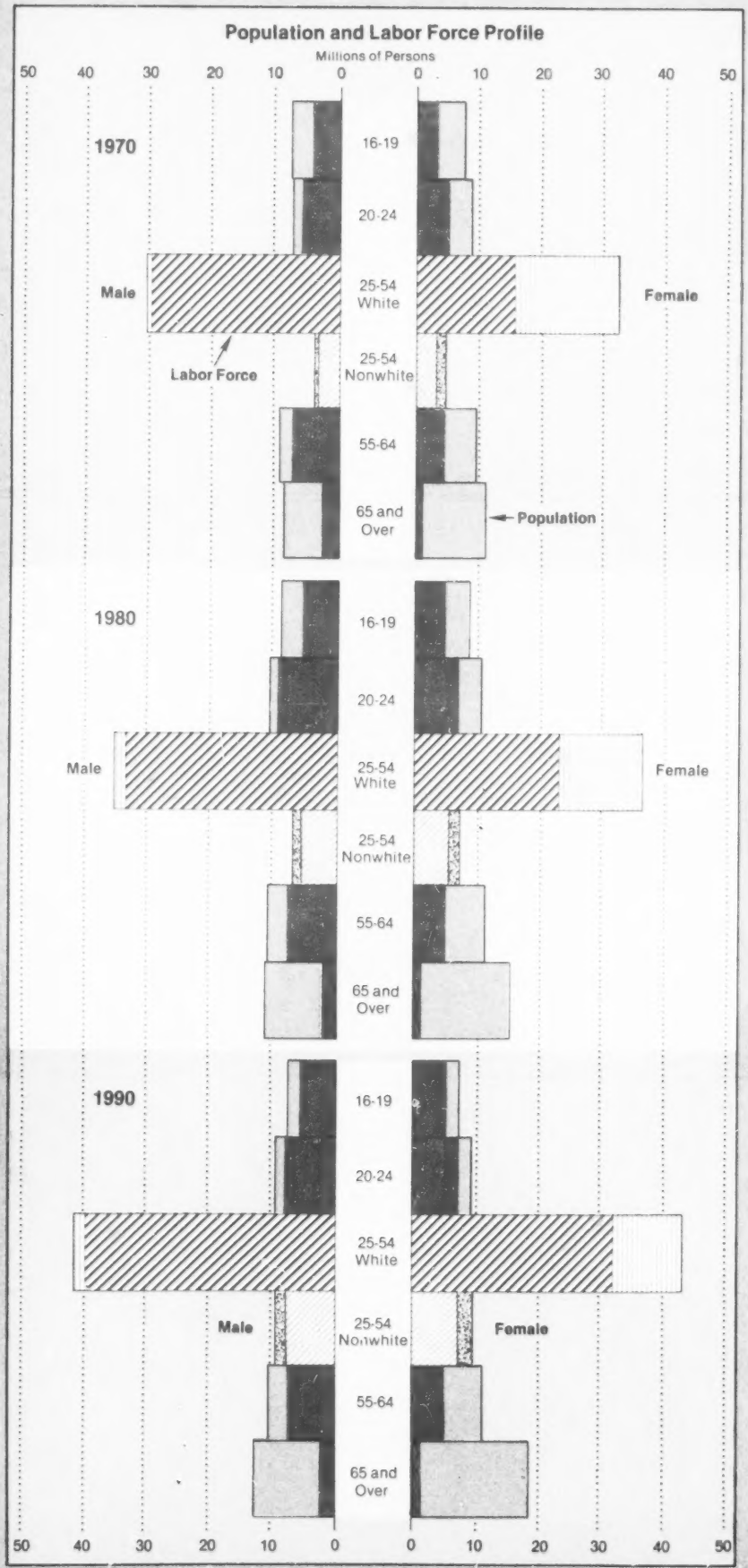


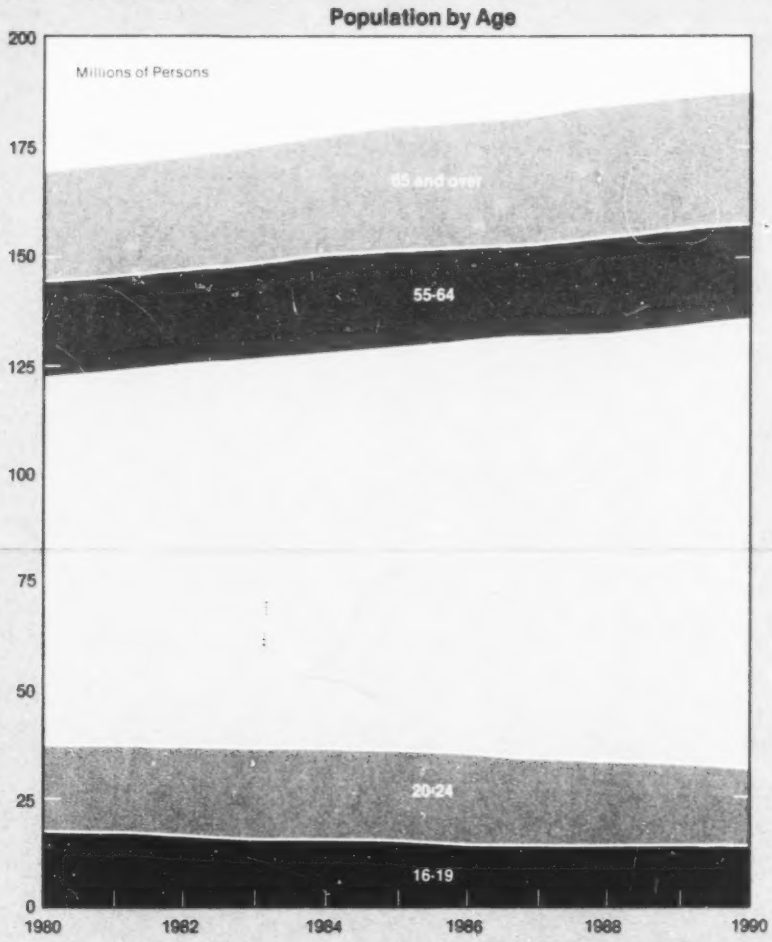
There have been four major changes in the pattern of population growth in the 20th century. Waves of new immigrants, largely young adults, swelled the growth rate in the first two decades. The subsequent decline in immigration, deaths in World War I, and the depression substantially lowered the growth rate in the 1920's and 1930's. Following World War II, the birth rate increased enormously, raising the population growth rate in the first two postwar decades. Since then, the birth rate has been significantly lower, reducing population growth rate once again.

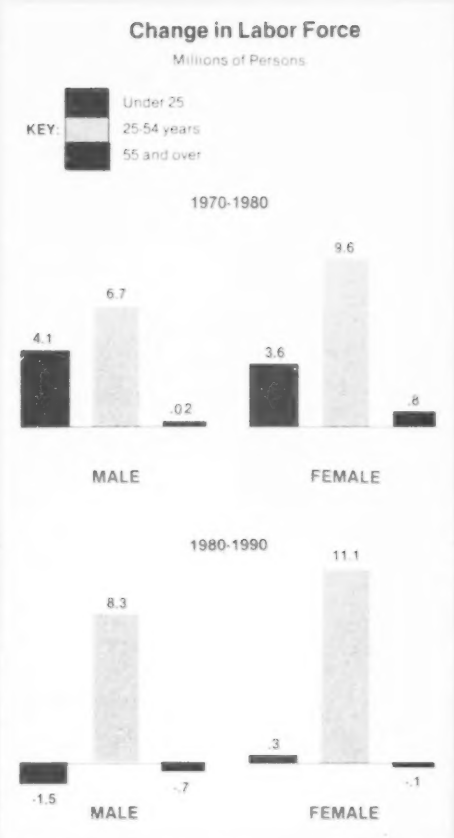
The shifts in the population growth rate are reflected in the quite uneven age distribution of Americans. Those born roughly between 1920 and 1945 were between 35 and 60 years old in 1980. As a result of a reduced birth rate during 1920-1945, the rate of increase in the number of men and women in this group has been lower than that for the immediately older group (those born before 1920, who were over 60 in 1980). This relative scarcity of potential workers has been a factor giving impetus both to automation and to higher labor force participation.

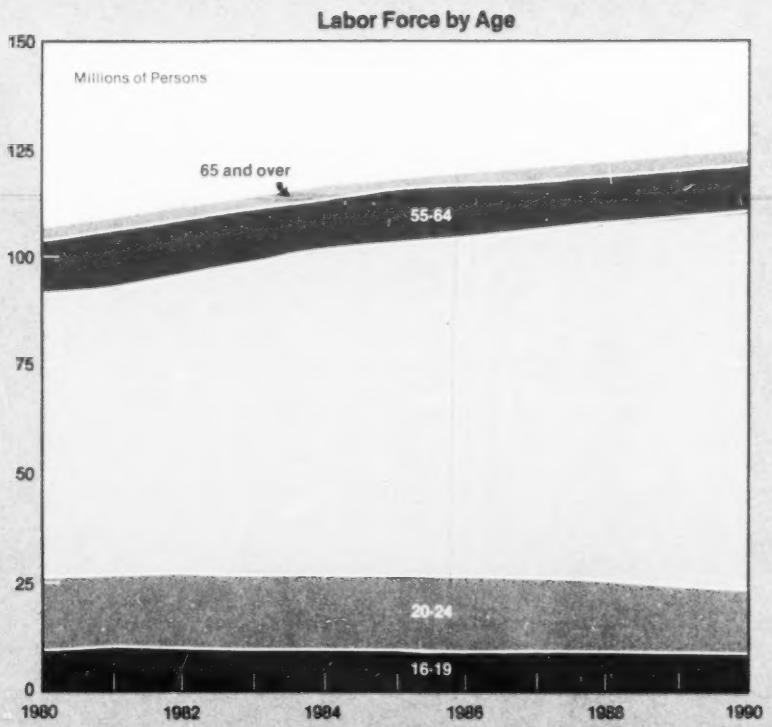
Those born roughly between 1945 and 1965 were between 15 and 35 in 1980. This is the so-called "baby-boom generation." The rate of increase in the number of people in this group has been higher than that of the older group, but the labor force participation of young people continued to rise. These two factors generated an enormous increase in the demand for jobs. The birth rate began to decline again in the mid-1960's, and this will moderate the growth of the labor force in the 1980's. However, the expectation is that labor force participation will continue to increase in the 1980's, and the problem of generating sufficient economic growth to absorb the labor force entrants (the pressure of people on people) will persist in this decade.

Although the Bureau of Labor Statistics defines the working-age population as everyone aged 16 or older, not all 16 year-olds immediately enter the labor force, and their labor force par-

Population and Labor Force

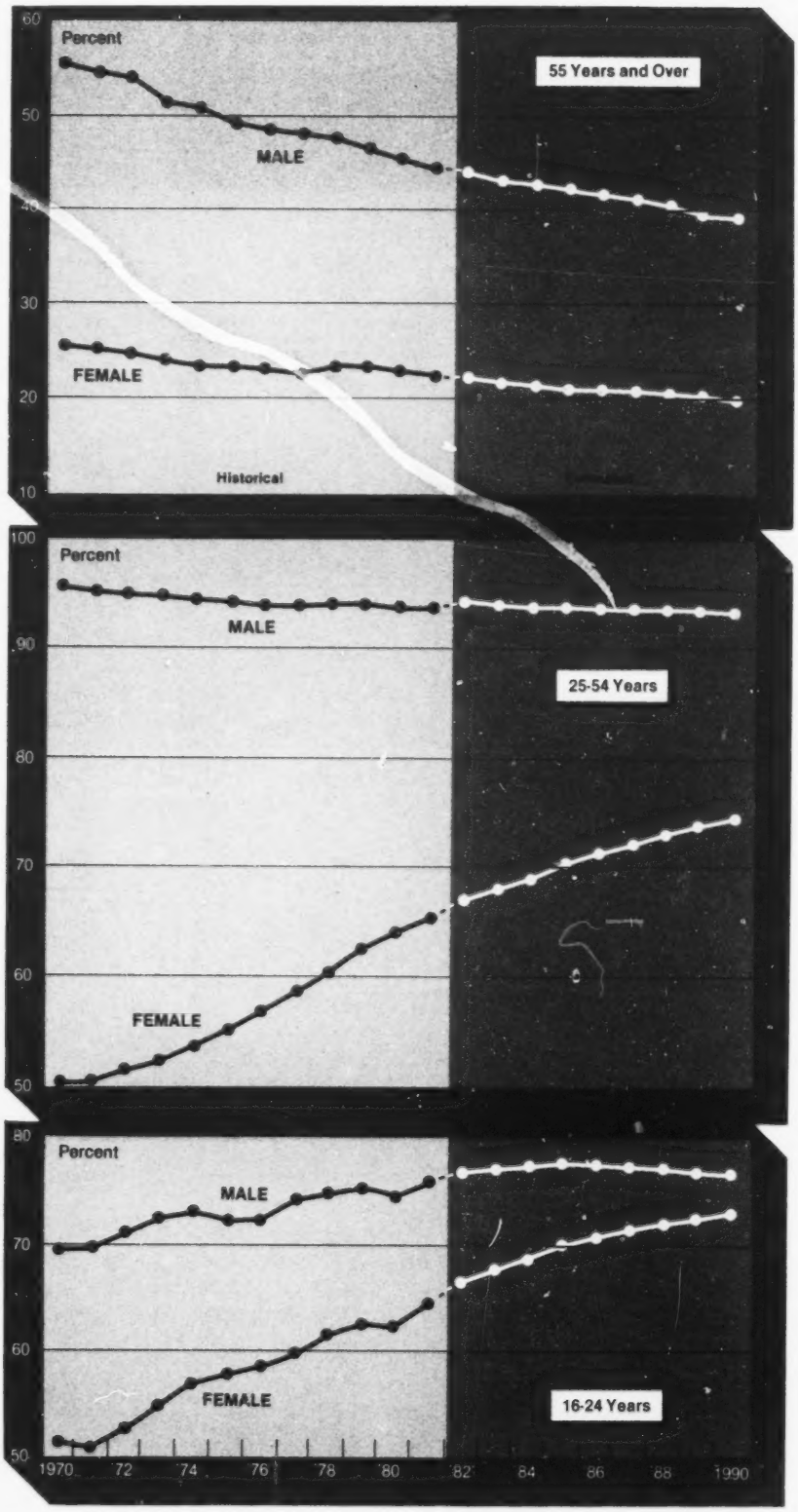






Labor Force Participation Rates

By Age and Sex



ticipation rate is substantially lower than that for adults. Another well-established pattern is that the proportion of men in the labor force is higher than that of women. But both patterns have been growing less pronounced, and this will continue in the 1980's. In 1970, 69% of men aged 16 to 24 were working or looking for work. A decade later, that rate had climbed to 74%, and it is expected to rise to 77% by 1990. Conversely, the rate for men aged 25 to 54, was 96% in 1970, 94% in 1980, and is projected to be about 94% in 1990.

For women aged 16 to 24, the participation rate was 51% in 1970, 62% in 1980, and is projected to be about 73% by 1990. Thus, the proportion of young women engaged in economic activity has been rising sharply, and it is anticipated that it will be almost equal to that of men of the same age by the end of the decade. The participation rate for women aged 25 to 54 was 50% in 1970, rose to 64% in 1980, and is projected to be about 74% by 1990—a sharp contrast to the essentially flat participation rate of men in the same age group. On the other hand, the participation rate of women in the 25 to 54 group will remain significantly below that of men of the same age through the end of the decade, unlike the situation in the younger group where male and female participation rates are converging.

The decline in the birth rate that began in the mid-1960's implies not only that the population growth rate has slowed, but also that the population and labor force will become progressively older in the 1980's. The Bureau of Labor Statistics projections imply that the decade will see the U.S. labor force expanding faster than the population. Some World Bank projections suggest that this will probably be the course in other major developed economies, not only through the end of the decade but, perhaps, through the end of the century.

Ken Goldstein

Sources: World Bank; Bureau of Census; Bureau of Labor Statistics; The Conference Board.

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